

BEFORE THE  
POSTAL REGULATORY COMMISSION  
WASHINGTON, DC 20268-0001

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Notice of Discover Financial Services

Notice is hereby given that the attached letter was sent by Cheryl O'Day of Discover Financial Services to Chairman Goldway yesterday.

Respectfully submitted,

/s/ Robert J. Brinkmann  
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The Honorable Ruth Goldway  
Chairman  
Postal Regulatory Commission  
901 New York Avenue, NW, Suite 200  
Washington, DC 20268-0001

April 29, 2013

Dear Chairman Goldway:

Discover Financial Services (DFS) read with great concern the Commission's views, expressed in the recent Annual Compliance Determination for FY 2012, on the matter of whether our Negotiated Service Agreement (NSA) with the Postal Service was profitable or not.

In terms of the ACR findings, we understand that the Commission's conclusion that the Discover NSA lost money for the Postal Service is largely based upon the use of a class-wide "elasticity" calculation that suggests Standard mail letter volume is not very sensitive to price fluctuations, and that much of DFS' marketing mail growth would have happened anyway. In fact, we understand that a senior PRC staff member acting as the Public Representative has suggested that the rationale behind these elasticity results are that direct mail standard letters are a monopoly product without direct substitutes, and that postage costs make up only a small portion of the total cost of producing and distributing these direct mail products. While we understand that a person in this capacity does not speak for the Commission or the Commission staff when acting in that capacity, we still find this suggestion very troubling and are concerned that others may share that view.

First, with respect, DFS does not think that the behavior of individual companies is accurately reflected in the measurement of the rate of response to price change of an entire group that includes *all mailers* of Standard Class letter mail, a very diverse group that includes letters that are marketing mail and letters that are not. We believe that different companies have very different sensitivities to mail and mail rates, and our experience is that those sensitivities change all the time, varying from month to month if not week to week.

Second, for DFS direct marketing standard mail letters are a not a monopoly product, they do have multiple substitutes, and they are price sensitive. To support our opinion, we would like to share DFS' approach to the use of mail, to explain why the provisions of our NSA have incited us to mail more than we would have absent those incentives, and to clarify why we believe that the net result has been profitable for the Postal Service.

As to the price and sensitivity, for DFS, postage is by far the largest single cost of any direct mail campaign, representing well over 50% of the total cost per piece. Based on our knowledge of the industry, this is true for direct mail campaigns in general. For us, postage is one of the largest expenses for our company, and mail is also our most expensive marketing channel, so

this in itself makes postage a very sensitive and closely managed expense. Therefore, any strategy we can utilize to improve our return on investment in this area attracts significant attention and prompts action.

In fact, our NSA prompted action on our part that ended up increasing the profit (not merely the volume) of the mail that the Postal Service receives from DFS *by more than 10 percent* in just one year and *by an additional 5%* in the year after. Increases of that magnitude simply do not happen by themselves, particularly in still-recovering and conservative economic times like these. It is also noteworthy that our increase in mail volume is relative to a baseline that, I believe, did not dip down as far as our competitors during that time, so that makes our 10 to 15% "recovery" that much more pronounced. On a related note, in terms of the effect of the incentives on DFS, while the deal was effective in April 2011, it was actually signed several months before that, in December 2010. In December 2010, our confidence level in the deal receiving regulatory approval was quite high since, based on our own analysis, we believed this NSA was clearly of mutual benefit for both the Postal Service and for Discover.

Additionally, I should also note that the incentives created by the NSA are meant to allow our company to meet our spend threshold by any combination of First Class and Standard mail that we choose, and thus these incentives are designed to work across campaigns and across classes to result in overall revenue and *profit* growth for the Postal Service. They are not incentives aimed at any particular class or category of mail, so to consider the NSA as somehow incenting specific pieces but not others is at odds with the core strategic goal of the NSA.

As the Postal Service has reported, we received a \$5.6 million rebate after the first year. This was in exchange for increasing *the profitability* to the Postal Service of DFS's First Class and Standard mail by 10 percent in the first year alone, an increase of \$24.8 to \$26.8 million, according to the Postal Service's calculation. Incentives were created to change behavior. The incentives worked, and we achieved the mutual benefit that both we and the Postal Service had hoped for.

This NSA influenced our marketing plans regarding mail volume during its first and second year, and is poised to do so through our third year. Although the threshold for benefit in year three is a tall order, we will be striving to hit this threshold. Each month as we monitor our spend and response rates on all of our campaigns, the NSA threshold for receiving benefits is also closely monitored and influences our plans. From the Postal Service's perspective, this was *exactly* the point of the NSA—to incent us to change our behavior as we measured the price and effectiveness of mail against its competitors. Without an NSA in place, any lift we would have received in the mail channel would have been at a higher price, which would have negatively impacted the extent to which we used the mail channel relative to the other marketing channels.

So the assumption that standard mail letters are not sensitive to price is, as described above, fundamentally flawed. And in addition, as we will describe below, the notion that standard mail letters are a monopoly is inconsistent with the reality of current marketing practices. While



technically, there is a postal monopoly over standard letters in the print area, marketing channel decisions today are made in a *highly* competitive environment, and mail is not exempt from that decision-making process.

As you know, DFS makes extensive use of the mail to market its financial services products and is one of the Postal Service's largest customers. Almost all of our use of the mail marketing channel is done by either First Class or Standard mail letters, although our use of First Class mail for marketing purposes has diminished significantly since our previous NSA. While we do still make use of First Class in some instances, that number is but a shadow of what it used to be. This is because First Class marketing mail is price sensitive, and the response we receive to our First Class marketing mail generally has not been justified by the incremental price relative to Standard.

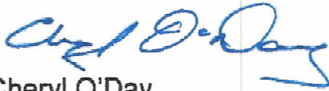
Standard mail, in turn, is in competition with our extensive use of nearly every other marketing channel in our integrated marketing efforts, including various online and email marketing techniques such as search engine optimization, pop up ads, mobile offers and social media. In addition, we use sponsorships of the Orange Bowl, NCAA football and NHL, a partnership with Six Flags, television commercials, mobile billboard advertising, and others. However online is our lowest cost channel by a significant margin, and not only allows us to reach a larger audience with greater frequency, but it is also the fastest growing channel. This growth would have accelerated without the benefit of our NSA to the mail channel.

When we design a campaign, we continuously analyze the response rate of each channel and the price we incur for that response. Not surprisingly, the channels that provide the greatest response for the best price usually receive more of our marketing dollars, and the competition for those dollars among marketing channels is exceptionally intense. Since the prices and response rates of channels change frequently, we constantly review channel metrics and shift dollars in ongoing marketing campaigns among channels throughout the year. So, in reality, in today's multifaceted marketing setting, where *direct competition* exists for our dollars among marketing channels that perform substitutable functions, direct mail—be it in letter or flat format—is just one channel that competes with many.

Madame Chairman, the elasticity of standard mail letters as a group may or may not be accurate any longer, but that elasticity bears no relationship to how DFS buys direct mail, and the highly competitive marketing decisions that DFS makes when it allocates marketing dollars among marketing channels. Our NSA has proven to be an effective means of creating a financial advantage for the mail marketing channel, which has translated into incremental growth of USPS profit at a time when it is needed most.

We appreciate your time in considering our views and your appreciation of the NSA process in general as an opportunity for mailers to collaborate with the Postal Service for mutual benefit.

Sincerely,



Cheryl O'Day  
Senior Manager, Marketing Operations  
Discover Financial Services

CC: The Honorable Mark Acton, Commissioner  
The Honorable Tony Hammond, Commissioner  
The Honorable Nanci Langley, Commissioner  
The Honorable Robert Taub, Commissioner